

RESPONSE TO BELL AND TAUB, "SOME ISSUES CONCERNING RISK
ADJUSTMENTS IN DAMAGES CALCULATIONS"

by

Thomas R. Ireland*

Bell and Taub criticize my 1997 paper in this journal on two grounds: First, that I am wrong that a discount rate for projecting a lost earnings stream should be free of default risk; Second, that I have supposedly made some errors in my discussion of differences between default risk and inflation risk. I will deal with each issue in turn.

I. The Default Risk Issue

The primary reason that I do not advocate use of an interest rate containing a premium for the possibility of default is case law, not the double counting argument that I mentioned in my paper. The key decision is *Jones & Laughlin Steel Corp. V. Pfeifer*, 103 S.Ct. 2541 (1983). Bell and Taub mention this case, but suggest that "the court's decision in this matter is not based on economic principles." That is a rather sweeping statement given that Pfeifer contains an extensive and complex consideration of all elements that must be considered in a personal injury loss calculation, but it is obvious that Bell and Taub think that the Pfeifer court was wrong in not allowing use of a discount rate containing a default risk premium. The important point is that Pfeifer sets a standard that is applied in many legal venues, both state and federal, regardless of the "rightness" or "wrongness" of the Pfeifer court's opinion regarding discount rates.

The real problem here is one of accounting for all factors that might limit a future earnings stream. That accounting can be made either in terms of projecting the stream itself or in choosing a discount rate which contains default risk characteristics exactly matching the intended earnings stream. If you account for all of the risks by probability discounts to the earnings stream itself, you should not also account for them by using a discount rate containing premiums to compensate for those risks. Bell and Taub point out that there are other default-like risks than the risks of non-survival, non-participation and unemployment. They give as an example the fact that productivity increases in the projected earnings stream may turn out to be higher or lower than projected. This may be an argument for including a productivity variance risk factor in projecting the earnings stream, but it is necessarily an argument for using a discount rate containing a default risk premium to account for this productivity variance factor.

Certainly, it seems logical to account for all risks to the earnings stream itself or to account for all risks with premia in the discount rate. Bell and Taub seem to be recommending some mix of accounting for some risks in the earnings stream directly and accounting for other risks using default risk premia in the discount rate, which would be almost impossible for any jury to understand. Their point about variance in productivity projections is well taken, but that does not lead to an argument in favor of mixing up both

* Thomas R. Ireland is with the Economics Department at the University of Missouri, St. Louis, Mo.

the earnings stream and the discount rate with risk factors. Given that the case law tells us that we must account for risks in the earnings stream and not in the discount rate, it seems reasonable to comply with the case law.

II. The Default Risk vs. Inflation Risk Issue

Bell and Taub did not understand my points of distinction between default risk, which is based on the risk that a certainty equivalent will not occur, and the various types of inflation risks that are often lumped together in discussions of "inflation risk." Bell and Taub are simply wrong when they say: "the nominal rate of interest on treasury securities consists of three components, the real rate of interest, the expected rate of inflation and the inflation risk premium." In reality, the nominal rate of interest on treasury securities actually consists of the *expected* real rate of interest, a premium for the expected variance in the expected real rate of interest, a premium for the unexpected variance in the expected real rate of interest, a premium for the risk of inflation that is equal to the expected rate of inflation, a premium for the known variance in the expected rate of inflation, a premium for the unknown variance in the expected rate of inflation, and various premia for the special tax characteristics of the securities involved. It does not seem useful for me to proceed further to try to figure out and explain what Bell and Taub were trying to say so that I can explain why it is incorrect. Much of the purpose of my paper was to try to explain the complexity of the various risks involved with inflation, which Bell and Taub seem not to have understood.

References

Ireland, Thomas R. 1997. "Forensic Implications of Inflation-Adjusted Bonds." This journal, 2(2):92-102.